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TREASURY FOR OASIA/LMOGHTADER
TREASURY PLEASE PASS TO OCC/AMCMAHON
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GOVERNORS, AND SAN FRANCISCO FRB/TERESA CURRAN

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SUBJECT: Economic Briefing for December 2005

[11](#). This cable summarizes selected recent economic events in Taiwan in December 2005:

- Macro Economic Performance
- Taiwan-China Integration
- Taiwan Banks
- New Tax
- Finance Reform
- Plan to Attract Investment
- High-speed Rail
- Scientific Cooperation
- Avian Influenza

Macro Economic Performance

[12](#). Taiwan's economy in the second half of 2005 rebounded from the impact of higher oil prices and higher interest rates that had dampened consumer demand in the United States, Japan, and Europe earlier this year. Y-o-y growth in Taiwan exports accelerated from below 5% in May and June this year to an average of 14% in October and November. Manufacturing production went from a 1% contraction in Q1 to y-o-y growth of 4% in Q3, 8% in October, and 10% in November. The service sector, accounting for 73% of Taiwan's total GDP, continued to expand in the second half of this year. On the other hand, agriculture, accounting for less than 2% of GDP, experienced further contraction this year due to bad weather and inability to compete with imported products. The unemployment rate in November declined to 3.9%, the lowest since April 2001. The consumer price index in November fell to 2.47%, down from a 7-year high of 3.58% in August.

[13](#). Both government and private think tanks predict Taiwan's economic growth in 2006 will be at or above 4%, based on expectations that developed nations will stimulate private consumption, and thus increase demand for Taiwan's exports. Growth in private investment in Taiwan in 2006 is expected to remain below 5% due to over-expansion in 2004. The Academia Sinica is concerned that the alternative minimum tax, due to start January 2006, will dampen private consumption and investment. Nevertheless, the Council for Economic Planning and Development, Taiwan's official economic planning agency, predicts real GDP growth of 4.5% in 2006 (predictions from other institutions include 3.3% by Global Insight, 4.1% by the World Bank and Asian Development Bank, 4.3% by the International Monetary Fund, 4% by Taiwan Institute of Economic Research and Chunghua Institution for Economic Research, 4.1% by the Directorate General of Budget, Accounting and Statistics (DGBAS), and 4.25% by Academia Sinica). The DGBAS, Taiwan's official statistical agency, predicts per capita GNP will reach US\$15,623 in [12006](#).

China Replaces USA as 2nd Major Source of Imports

[14](#). Taiwan's rapidly growing economic integration with China has led to China surpassing the United States as Taiwan's second major source of imports. In September 2005 Taiwan's imports from China totaled US\$1,643 million, for the first time exceeding the US\$1,569 million of imports from the United States. The gap broadened in October to US\$1,774.3 million from China versus US\$1,689.7 million from the United States. (Cross-strait trade statistics from the Bureau of Foreign Trade are currently available only through October 2005.) Taiwan's total imports have grown by double-digit rates over the past four years while imports from the United States have experienced a y-o-y decline for the past six months. China replaced the United States as Taiwan's major export destination in 2002. The percentage share of exports

to China has steadily increased from 19.6% in 2001 to 28% in September 2005. Meanwhile, the share of exports to the United States steadily fell from 22.5% to 14%. The gap will continue to broaden as Taiwan manufacturing firms increase production in China.

Improvement in Taiwan Banks

15. Taiwan banks significantly improved their financial standing in November 2005. Efforts to write-off bad debt and sell problem assets contributed to a decline of NT\$29.3 billion in non-performing loans (NPL) in November to NT\$425.8 billion, 36% below a year ago. Average NPL ratios in November dropped to 2.61%, down from nearly 12% in March 2002, 4.35% in November 2004 and 2.81% in October 2005. The number of local banks reporting NPL ratios above the 5% limit set by the Financial Supervisory Commission (FSC) in November 2005 fell to five from 29 a year earlier, and among the five, only three reported capital adequacy ratios below the FSC minimum requirement of 8%. One of the three (Business Bank of Hualien, BBH) was sold to Nassau Inn for NT\$1,000 million (US\$30 million) on November 28. Nassau is expected to improve and sell BBH rather than to hold and manage it.

16. In November 2005, seven of the nine remaining state-controlled banks reported declines in NPL ratios. The exceptions were Bank of Taiwan's NPL ratio in November increased to 1.61% from 1.53% in October, and Huanan Commercial Bank's remained unchanged at 1.80%. Changhwa Commercial Bank wrote off NT\$32.1 billion of bad debt in November, resulting in a drastic drop in its NPL ratio from 5.36% in October to 1.76% in November. Taishin Financial Holding replaced the Ministry of Finance to become the largest shareholder in September 2005. The November NPL ratios of the four other state-controlled banks together with their October figures in parentheses are as follows:

- Land Bank of Taiwan: 3.34 (3.44%)
- Cooperative Bank of Taiwan: 3.21% (3.33%)
- Huanan Commercial Bank: 2.27% (2.31%)
- Business Bank of Taiwan: 4.57% (4.60%)

Legislation of Alternative Minimum Tax

17. On December 9, Taiwan passed a tax reform bill establishing an alternative minimum tax mechanism (AMT), Taiwan's first new tax in 20 years. The AMT will affect only businesses with annual income above NT\$2 million and individuals with annual income above NT\$6 million. The AMT tax rate will be 20% for individuals and 10 - 12% for businesses. The AMT will affect only about 0.3% of individual taxpayers and 0.9% of business firms, but will have a disproportionate impact on high-tech industries because of the tax exemptions they currently enjoy. Business leaders warn that the AMT may prompt further industrial relocation offshore and emigration of high-income people. The tax has broad popular support. Senior executives from some of Taiwan's leading information technology (IT) companies have publicly supported expanding taxation to high-tech firms. They believe that Taiwan's industry is well able to absorb what they perceive to be a fairly modest tax increase.

Progress in Second Stage of Finance Reform

18. In spite of strong resistance from labor unions and opposition legislators, Taiwan has accomplished two of the three goals for 2005 set in its second stage of financial reform. The goal not attained was that of selling controlling interest in a state-owned bank to foreign investors. Nevertheless, the MOF sold 22.5% of equity in Changhwa Commercial Bank to Taishin Financial Holding in July 2005. The Taiwan Development and Trust Company retreated from the banking sector in January 2005 by selling its banking department to Jihsun International Commercial Bank. The MOF merged seven state-owned banks into three in Q4 2005, reducing the number of state-owned banks to six (i.e., Bank of Taiwan (BOT), Mega Commercial Bank (MCB), Cooperative Bank of Taiwan (CBT), Land Bank of Taiwan, First Commercial Bank, and Huanan Commercial Bank). The three merger cases are as follows:

-- On November 8, Cooperative Bank of Taiwan (CBT) announced its merger with Farmers Bank of China (FBC). The merger of these two banks will make CBT the third largest bank with a market share of 10% in assets.

-- On November 17, Bank of Taiwan (BOT) announced it would take over the banking department of the Central Trust of China. This acquisition will increase the BOT's market share to 11.59% in assets, the largest among local banks.

-- In October, the Mega Financial Holding Company (MFHC)

decided to merge its two subsidiary banks (i.e., International Commercial Bank of China and Chiao Tung Bank) into Mega Commercial Bank (MCB) in March 2006. The MFHC announced on December 16 it had acquired 26% equity in Business Bank of Taiwan (BBT) and will merge BBT into MCB over the next three years. The merger will make MCB the second largest bank with market share of 10.89% in assets.

EY Revitalization Plan to Attract Investment

9. On November 28, 2005, Taiwan's Executive Yuan (EY) announced six measures to encourage "traditional" industries (non-high-tech) to invest in Taiwan. The measures target Taiwan firms that have invested in China. The EY hopes these measures will boost investment in Taiwan by NTD 137 billion (about USD 4 billion). The measures include funding for subsidized rents in industrial parks, expansion of existing industrial parks, low-interest financing for investors, converting two industrial parks into free trade zones, and permitting additional employment of foreign workers by firms in labor-intensive industries. Some observers have pointed out that the new alternative minimum tax (see para 7) will counteract some of the benefits that these six measures are intended to create.
MOTC Considering Buying High-Speed Rail

10. On December 26, the Ministry of Transportation and Communications (MOTC) Minister Lin Ling-san confirmed that the Taiwan government was considering buying the build-operate-transfer (BOT) high-speed rail project now underway. Also on December 26, MOTC released a report on the financial situation of the Taiwan High-Speed Rail Corporation (THSRC). The report indicated that the one-year postponement of the high-speed rail's inauguration would raise the total cost of the project by NT\$ 14 billion (about USD 426 million) to NT\$ 480 billion (USD 14.6 billion). MOTC estimated that THSRC needed to raise at least NT\$ 65 billion (USD 2 billion) in additional capital to complete the project, twice previous estimates.

Scientific Cooperation

11. AIT/ESTH participated in an NSF-Taiwan NSC discussion of Taiwan's participation in the Atacama Large Millimeter Array (ALMA) project to build an array of 50 radio telescopes in the Atacama Desert of Chile. Taiwan will provide about \$30 million funding for the project over a ten-year period, enough for two or three of the telescopes. A letter of intent was signed at the end of the visit by the NSF staff with the proviso that AIT and TECRO should sign an agreement on the matter before funding is committed.

U.S. Companies Prepare for Avian Influenza

12. On December 16, Corning Company Taiwan gave an Avian Influenza (AI) presentation to Amcham which focused on the lessons Corning had learned from dealing with the SARS outbreak of 2003 on strategies to combat infectious disease outbreaks. Corning said it would rely on local government to provide Tamiflu, if needed. The presentation was an indication of the preparations for AI that some U.S. companies have made.

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